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No. 88-1177

In the Supreme Court of the United States

OCTOBER TERM, 1988

MUSTANG FUEL CORPORATION, FORMERLY MUSTANG ENERGY CORP., PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION IN OPPOSITION

WILLIAM C. BRYSON
Acting Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

CATHERINE C. COOK
General Counsel

JOSEPH S. DAVIES
Deputy Solicitor

JOANNE LEVEQUE
Attorney
Federal Energy Regulatory Commission
Washington, D.C. 20426

18 pp

QUESTION PRESENTED

Whether the court of appeals properly upheld the decision of the Federal Energy Regulatory Commission establishing "fair and equitable" rates for petitioner's natural gas transportation service under Section 311(a)(2) of the Natural Gas Policy Act of 1978, 15 U.S.C. 3371(a)(2).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-31a) is reported at 859 F.2d 1447. The order of the Federal Energy Regulatory Commission establishing petitioner's rates (Pet. App. 34a-62a) is reported at 31 F.E.R.C. ¶ 61,265 (1985). The order of the Federal Energy Regulatory Commission on rehearing (Pet. App. 63a-93a) is reported at 36 F.E.R.C. ¶ 61,001 (1986).

JURISDICTION

The judgment of the court of appeals (Pet. App. 32a-33a) was entered on October 17, 1988. The petition for a writ of certiorari was filed on January 17, 1989 (Tuesday after a Monday holiday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Under Section 311(a)(2) of the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. 3371(a)(2), the Federal Energy Regulatory Commission (FERC or Commission) may authorize an intrastate pipeline to transport natural gas on behalf of any interstate pipeline or local distribution company served by an interstate pipeline. The Commission must establish "fair and equitable" rates and charges for such transportation service that "may not exceed an amount which is reasonably comparable to the rates and charges which interstate pipelines would be permitted to charge for providing similar transportation service." Section 311(a)(2)(B)(i) of the NGPA, 15 U.S.C. 3371(a)(2)(B)(i). In order to set "fair and equitable" rates, the Commission must "establish the method for calculating an amount necessary to * * * reasonably compensate any intrastate pipeline for expenses incurred" and "provide an opportunity for such pipeline to earn a reasonable profit on such services." Section 311(a)(2)(B)(ii) of the NGPA, 15 U.S.C. 3371(a)(2)(B)(ii).

Under the Commission's regulations implementir g Section 311(a)(2), intrastate pipelines may base rates for interstate service on the methodologies used by, or the rates on file with, their respective state regulatory agencies. See 18 C.F.R. 284.123(b)(1). If an intrastate pipeline does not so elect, or is not subject to state regulation, the pipeline must file an application with the Commission for approval of its proposed rates and charges, along with information showing that they are "fair and equitable." See 18 C.F.R. 284.123(b)(2)(ii).

2. Before 1981, petitioner Mustang Fuel Corporation (petitioner or Mustang), a private intrastate pipeline located in Oklahoma, transported natural gas from producing areas to electrical generating stations owned by

Oklahoma Gas and Electric Company (OG&E).[1] In January 1981, petitioner contracted with El Paso Natural Gas Company (El Paso), an interstate pipeline, to transport gas for El Paso through petitioner's existing facilities under Section 311(a)(2) of the NGPA, 15 U.S.C. 3371(a)(2). That agreement also required petitioner to construct a new segment of pipeline, an additional compressor station, and certain gathering lines, all of which were needed to meet El Paso's transportation requirements. Pet. App. 2a, 34a-35a, 64a.

Before transporting gas for El Paso on September 30, 1981, petitioner sought the Commission's approval of a proposed transportation rate of 22.29 cents per Mcf (thousand cubic feet). By orders entered in May and July 1982, the Commission approved a settlement. See *Mustang Fuel Corp.*, 19 F.E.R.C. ¶ 61,168, on reh'g, 20 F.E.R.C. ¶ 61,057 (1982).[2] Petitioner agreed to transport gas for a term of 15 years at an "annual average daily limit of

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[1] Petitioner was not regulated by any state authority. Pet. App. 5a n.1.

[2] As a threshold matter, the Commission concluded that the "fair and equitable" standard contained in Section 311(a)(2) should be implemented through the Commission's traditional cost-of-service ratemaking principles. In other words, a "fair and equitable rate" is "one that reasonably compensates an intrastate pipeline for expenses incurred by the pipeline for providing the service plus an opportunity for the pipeline to earn a reasonable profit" (*Mustang Fuel Corp.*, 19 F.E.R.C. ¶ 61,168, at 61,318 (1982)).

Under cost-of-service ratemaking, "a unit transportation rate is determined by dividing the total annual (or annualized) cost of providing service (inclusive of a return on the pipeline's investment) by the annual (or annualized) volumes to be transported" (Pet. App. 13a n.10 (internal quotation marks and citations omitted)).

130,000 Mcf" (Pet. App. 36a).[3] For the one-year period ending September 30, 1982 (Period I), the Commission approved petitioner's proposed rate of 22.29 cents per Mcf. Thereafter, by September 30, 1982, and at least once a year for the duration of the period of service, petitioner would seek, under Regulation 284.123(b) (18 C.F.R. 284.123(b)), the Commission's approval of the rates to be charged to El Paso. Pet. App. 35a-36a.

On September 30, 1982, petitioner applied to the Commission for an approximate 50% rate increase, from 22.29 cents per Mcf to 32.21 cents per Mcf. That increased rate would obtain for a period up to twelve months beginning October 1, 1982 (Period II). On May 23, 1983, petitioner requested an additional rate increase to 34.30 cents per Mcf, effective for the twelve-month period beginning on that date (Period III). The Commission scheduled appropriate rate proceedings. In the meantime, under Regulation 284.123(b)(2)(i) and (ii), the Commission accepted petitioner's new rates for filing, subject to refunds to El Paso if it ultimately determined that those rates were excessive under Section 311(a)(2) of the NGPA, 15 U.S.C. 3371(a)(2). Pet. App. 7a, 36a.[4]

3. On June 4, 1985, the Commission issued an order setting fair and equitable rates for petitioner's transportation of gas that were lower than those sought by peti-

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[3] Under the "minimum bill" provision of the contract between petitioner and El Paso, El Paso would pay petitioner each month for transportation of a "minimum daily quantity," regardless of whether petitioner actually transported and delivered that volume of gas to El Paso. Pet. App. 6a.

[4] Since petitioner filed its second rate increase in May 1983, "Period II" covered the period October 1, 1982 through May 22, 1983. "Period III" covered the period from May 23, 1983 through April 30, 1984. Pet. App. 7a.

tioner.[5] In addition, the Commission invalidated the "minimum bill" provision of petitioner's agreement with El Paso and ordered petitioner to refund any charges collected for natural gas not actually transported for El Paso. Pet. App. 34a-62a.

a. Having concluded earlier to apply cost-of-service ratemaking to the statutory standard of "fair and equitable," see note 2, *supra,* the Commission found that the record did not adequately support the cost projections submitted by petitioner. It therefore substituted petitioner's "actual system-wide cost of service and average rate base for the period ending September 30, 1983, the most current twelve-month period for which Mustang provided unadjusted figures," for petitioner's projected costs (Pet. App. 40a). As a result, the Commission lowered petitioner's proposed rates to 28.93 cents per Mcf for Period II and 33.75 cents per Mcf for Period III (*id.* at 50a, 61a-62a).

b. The Commission also rejected the proposed "minimum bill" provision in the contract between petitioner and El Paso, which permitted petitioner to charge El Paso transportation rates for a minimum of 130,000 Mcf of gas per day, regardless of whether El Paso actually took that quantity (see note 3, *supra*). It explained that the "risk of underutilization of Mustang's facilities should be shared between Mustang and El Paso. This sharing of underutilization risk provides Mustang some incentive to perform Section 311 transportation but to avoid overbuilding Section 311 facilities" (Pet. App. 53a). Since petitioner's minimum bill would have substantially shifted that risk to El Paso, the Commission held that it was not "fair and equitable" (*id.* at 54a).

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[5] The Commission's order established petitioner's rates only for Period II and Period III (Pet. App. 36a).

c. Finally, having determined that petitioner's proposed rates and minimum bill provision exceeded the statutory "fair and equitable" standard, the Commission ordered petitioner to refund to El Paso those excess funds collected. Pet. App. 62a.[6]

4. The court of appeals (Pet. App. 1a-31a) denied Mustang's petition for review of the Commission's order, except to the extent that it directed the Commission to recalculate the Period II rate by using the "actual cost data" for that term (*id.* at 24a-25a, 31a-33a).

a. The court concluded that the Commission, exercising its discretion to interpret the broad statutory directive contained in Section 311(a)(2) to establish "fair and equitable" rates, had properly chosen to implement the statute through traditional cost-of-service ratemaking, a matter which petitioner did not challenge (Pet. App. 10a-13a). Under such circumstances, FERC has discretion to decide how costs associated with underutilized capacity should be allocated in order to balance its "obligation to interstate ratepayers with the duty to intrastate pipelines under Section 311(a)" (*id.* at 17a). Accordingly, the court chose to "defer to FERC's interpretation of the 'fair and equitable' standard and to its allocation of the risks of underutilization in setting transportation rates" (*id.* at 18a).

b. The court of appeals upheld the Commission's use of actual cost data, as opposed to petitioner's projected

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[6] In its order, the Commission also invalidated the minimum bill provision in effect for Period I, and thus ordered petitioner to refund excess funds collected during that term. Pet. App. 55a-57a. On rehearing, the Commission agreed with petitioner that such an order, under the circumstances, was wrong. It therefore rescinded that order, permitting petitioner to collect from El Paso under the minimum bill provision until October 1, 1982 (the beginning of Period II). *Id.* at 72a-76a.

cost data, in setting transportation rates, observing that "Mustang has identified no authority to support its contention that the use of actual cost data is improper" (Pet. App. 21a).[7] Moreover, the court rejected petitioner's claim that the Commission engaged in impermissible retroactive ratemaking by switching from projected cost figures for Period I to actual cost figures for Periods II and III. That prohibition applies only to rates that have been finally approved. Here, "FERC regulations make clear that unapproved rates are collected subject to a later refund if the filed rates are determined to be in excess of that which is fair and equitable" (*id.* at 22a). The court thus concluded that FERC's decision to rely on actual cost data is not tantamount to retroactive ratemaking. *Id.* at 22a-23a.

c. The court of appeals also upheld FERC's invalidation of the minimum bill provision, concluding that the reallocation of the risk of underutilization to petitioner resulting from invalidation of that provision was within the Commission's authority. The court dismissed petitioner's claim that the Commission's "order is discriminatory * * * because FERC approved minimum bills for interstate pipelines during the same period" (Pet. App. 27a). In the court's view, the differences between FERC's regulatory jurisdiction over interstate pipelines' transportation of gas and transportation of gas by intrastate pipelines under Section 311(a)(2), together with the Commission's allocation of the risk of underutilization under Section 311(a)(2), supported the Commission's decision to treat minimum bills differently in the intrastate context. Pet. App. 27a-28a.

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[7] The court agreed with petitioner, however, that the Commission erred in not relying on updated figures reflecting petitioner's actual costs for Period II. Accordingly, it directed the Commission to recalculate the Period II rate by using the "actual cost data" for that term. Pet. App. 24a-25a.

d. Finally, the court of appeals, following *Permian Basin Area Rate Cases,* 390 U.S. 747, 770 (1968), rejected petitioner's contention that the Commission's "refund order which forces it to repay revenues below its actual cost of service is confiscatory and unconstitutional" (Pet. App. 29a). Noting that the Commission's regulations make clear that any Section 311(a)(2) rates collected before final Commission approval are subject to refund, and that a pipeline may seek judicial review of that decision, the court held that FERC's procedures were consistent with the Due Process Clause (*id.* at 31a).

ARGUMENT

The decision of the court of appeals is correct. It does not conflict with any decision of this Court or of any other court of appeals. Accordingly, further review by this Court is not warranted.

1. Petitioner principally contends (Pet. 16-21) that the Commission misapplied the "fair and equitable" standard of Section 311(a)(2) of the NGPA, 15 U.S.C. 3371(a)(2), by not setting rates that would guarantee petitioner the return of a "reasonable profit" and the recovery of "expenses incurred." As the court of appeals recognized, the " 'fair and equitable' standard in Section 311(a)(2) is subject to a variety of interpretations" (Pet. App. 10a). FERC's reasonable construction of the statute it administers merits deference, and the Commission's reading of Section 311(a)(2) finds support in the legislative history (Pet. App. 13a (citing H.R. Rep. No. 1752, 95th Cong., 2d Sess. 107-109 (1978)). Accordingly, the court of appeals correctly upheld the Commission's conclusion that Section 311(a)(2) called for traditional cost-of-service ratemaking (Pet. App. 12a-13a).

Under that established ratemaking methodology, rates are set that give a pipeline an opportunity to recover its costs and earn a profit on its property devoted to the public service. See *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944). In other words, the Commission approves or establishes rates based on appropriately documented costs, which are allocated among the pipeline's customers based on selected volumes of business. If the pipeline surpasses its targeted volume, it will certainly recover the allocated share of costs on its business. If, however, the pipeline does not attain that target, it will not fully recover its costs. Accordingly, although this regulatory regime enables a pipeline to recover expenses and earn a profit, it does not guarantee that outcome where the pipeline's facilities are underutilized.

Here, the Commission correctly set petitioner's rates, taking into account petitioner's actual costs and the fact that its minimum bill provision improperly allowed petitioner to charge El Paso for transportation service it had not rendered. Under Section 311(a)(2) of the NGPA, as the court of appeals recognized, the Commission properly established rates that required petitioner to bear the risk where utilization of its facilities is below the levels which have been established for rate design purposes.

In this regard the Commission views the proper apportionment of the risk of underutilization of new and of existing facilities somewhat differently (Pet. App. 48a). In both instances, however, the Commission's application of Section 311(a)(2), which does not ensure that petitioner will in fact recover expenses and earn a profit from its transportation services, is consistent with the statutory mandate.

The NGPA allows pipelines to build new facilities without first obtaining the Commission's approval. Con-

sequently, it is important that the Commission be able "to encourage the intrastate pipeline to make a sound assessment of the need for and economic viability of the facilities" (Pet. App. 16a (emphasis and citation omitted)). In this instance the Commission, through a condition established at the outset of the Mustang-El Paso service, required that rates filed by Mustang to cover costs on its major new facility be predicated on a specified minimum level of volumes; then, if there were excessive levels of unused capacity, the risk would fall on the project's builder, not the utility ratepayer.

Most of Mustang's facilities predated the NGPA and the Commission here gave petitioner the opportunity to recover its costs and earn a return on equity if the pipeline met the levels of service reflected in the rates petitioner itself filed.[8] If petitioner's actual volume of transportation fell below the levels petitioner forecasted, it either could seek out additional customers or file new rates with adjusted targeted levels. This regulatory regime thus clearly satisfies the statutory standard for ratemaking.

2. a. Petitioner further contends (Pet. 21-26) that the decision below conflicts with constitutional principles articulated in decisions such as *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944), and *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968). But as mentioned above, the regulatory regime, which gave petitioner the opportunity

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[8] Petitioner also contends that the Commission's "orders have shoved up on an intrastate pipeline 100% of the financial impact of El Paso's, and its customers' misjudgments of their markets and errors in their projections between 1982 and 1985" (Pet. 23). That claim is groundless. Although El Paso makes the initial projections, petitioner need not accept those estimates. Absent the artificial protection of a minimum bill provision, petitioner will likely scrutinize El Paso's projections in order to make certain that its proposed rate will reflect its actual costs. See Pet. App. 27a.

to recover its costs and earn a return on equity if the pipeline met the levels of service reflected in the rates petitioner itself filed, clearly satisfies constitutional requirements for ratemaking.

As this Court recently explained in *Duquesne Light Co.* v. *Barasch,* No. 87-1160 (Jan. 11, 1989), slip op. 14, a regulated utility is entitled to earn a return on property used to carry out its public service obligation comparable to that which would be available under competitive conditions for businesses with similar risks. See *FPC* v. *Hope Natural Gas Co.,* 320 U.S. at 603; *Bluefield Water Works & Improvement Co.* v. *Public Service Comm'n,* 262 U.S. 679, 692-693 (1923). That fundamental principle does not require, as petitioner has suggested (see Pet. App. 13a), that the regulating authority insure utilities against losses from failed business ventures or impose such losses on customers who have not benefitted from the utilities' expenditures. For as the Court explained in *Market Street Ry.* v. *Railroad Comm'n,* 324 U.S. 548, 566 (1945), the Due Process Clause does not require that "regulation * * * assure that the regulated business make a profit." Nor may that Clause "be applied to insure values or to restore values that have been lost by the operation of economic forces" (*id.* at 567).

b. Contrary to petitioner's contention (Pet. 24-26), the court of appeals correctly applied the so-called "end result" test set forth in *Hope Natural Gas.* Under that test, "it is the result reached [by operation of a utility's rate order] not the method employed which is controlling" (320 U.S. at 602). As the Court explained, "[i]f the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry * * * is at an end" (*ibid.*); see *Permian Basin Area Rate Cases,* 390 U.S. 747, 769-770 (1968). The "guiding principle has been that the Constitution protects utilities from being limited to a charge for

their property serving the public which is so 'unjust' as to be confiscatory" (*Duquesne Light Co.*, slip op. 7); see *Pennell* v. *San Jose*, 108 S. Ct. 849, 857 (1988); *Covington & Lexington Turnpike Road Co.* v. *Sandford*, 164 U.S. 578, 597 (1896).

Here, the "end result" of the Commission's order gives petitioner the opportunity to earn a return comparable to that earned by firms with similar risks, but only on the services petitioner actually provides. The Commission's order therefore requires petitioner to repay rates collected under its minimum bill for volumes of gas it never transported for El Paso, as well as to reduce its rates to reflect actual costs (since petitioner did not adequately support its cost projections). That sound result certainly satisfies the standard announced in *Hope Natural Gas.*[9]

3. Finally, petitioner asserts (Pet. 26-27) that the court of appeals' treatment of the Commission's invalidation of the minimum bill provision conflicts with *East Tennessee Natural Gas Co.* v. *FERC*, No. 87-1765 (D.C. Cir. Dec. 9,

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[9] Petitioner also asserts (Pet. 27-28) that the court of appeals' decision conflicts with *Jersey Cent. Power & Light Co.* v. *FERC*, 810 F.2d 1168 (1987) (en banc). In that case, the District of Columbia Circuit held that, under *Hope Natural Gas, supra*, the Commission had erred in not adequately considering the utility's request to earn a return on expenditures for a cancelled nuclear power plant, where the utility claimed that it "has been shut off from long-term capital, is wholly dependent for short-term capital on a revolving credit arrangement that can be cancelled at any time, and has been unable to pay dividends for four years" (810 F.2d at 1181). Unlike the utility in *Jersey Cent. Power & Light Co.*, petitioner has made no showing that it faces that "sort of deep financial hardship" as a result of the Commission's ratemaking (810 F.2d at 1181 n.3). On the contrary, the Commission's action, after holding hearings, afforded petitioner a fair opportunity to collect its actual cost of service and a reasonable rate of return on equity in light of the risks of its enterprise. The court of appeals' decision is thus consistent with *Jersey Cent. Power & Light Co.*

1988). In that case, the District of Columbia Circuit held that the Commission, in connection with proposals for rate changes under Sections 4 and 5 of the Natural Gas Act, 15 U.S.C. 717c and 717d, may eliminate a minimum bill provision retroactively only where "[a]n interaction between proposed changes and existing rates * * * will *create* results that are unjust or unreasonable under *existing* Commission policy as it applies to the pipeline at the time it files its proposed rate changes" (slip op. 21 (emphases in original)). The instant case, however, does not involve the same situation.

Here, the case does not arise under Sections 4 and 5 of the Natural Gas Act, but under the different regulatory structure of Section 311 of the NGPA. Moreover, the Commission's order approving petitioner's Period I rates and initially authorizing petitioner's transportation service under Section 311(a)(2) of the NGPA cannot be construed as an open-ended approval of petitioner's rates or its minimum bill requirement. To the contrary, that order specifically required petitioner to file entirely new rate applications each year. *Mustang Fuel Corp.*, 19 F.E.R.C. ¶ 61,168, on reh'g, 20 F.E.R.C. ¶ 61,057 (1982); see Pet. App. 35a-36a. Under the Commission's rules, that meant petitioner had to apply for Commission approval of the rates each year, show that they were fair and equitable (18 C.F.R. 284.123(b)(2)), and refund any portions the Commission did not approve (18 C.F.R. 284.2). The Commission's action here was squarely in accordance with those established regulations and its earlier order.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

WILLIAM C. BRYSON
Acting Solicitor General

CATHERINE C. COOK
General Counsel

JOSEPH S. DAVIES
Deputy Solicitor

JOANNE LEVEQUE
Attorney
Federal Energy Regulatory Commission

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